

# THE TAX REFORM EXPERIMENT IN TRANSITIONAL COUNTRIES

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## Abstract

The last decade has been witness to one of the largest tax experiments in economic history, the transformation from centrally-planned to market-based tax systems. The cultural and institutional legacy of central planning has had a lasting impact on tax reform in countries in transition. The fundamental choices for reform were a 'big-bang' approach or an evolutionary approach. With the benefit of hindsight, we can now evaluate the choices made and whether or not basic advice was heeded. The tax systems that have emerged are, at least in some ways, satisfactory in terms of tax policy but deficient in terms of tax administration and enforcement. Experiences with tax reform have been diverse, and in some countries there has been very little reform at all. We conclude by examining what lessons have been learned during the first decade of transition.

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## 1. Introduction

The past ten years have been witness to one of the largest experiments in economic history, the transition of centrally-planned economies (CPEs) to market-based economies. Economic reform in the countries in transition (CITs) has encompassed virtually every sector of the economy, with varying degrees of success.<sup>3</sup> In particular, tax reform has been widely recognized as critical to the success of the economic transition experiment<sup>4</sup>.

The breadth and pace of tax reform has varied significantly, from those countries that have readily adopted western-oriented public institutions such as the Czech Republic, Estonia, Hungary, Latvia, and Poland, to those that have steadfastly refused to reform their governmental institutions, such as Belarus and Turkmenistan. The available evidence suggests that the scope, speed, and stability of economic policy reforms, including tax reforms, significantly influenced the ability of CITs to reestablish economic growth (or limit economic decline) during the transition (Barbone and Polackova, 1996; de Melo, Denizet, and Gelb, 1996; Fisher, Sahay, and Vegh, 1996, Havrylyshyn and Wolf, 1999). This paper reviews and evaluates the tax reform process during the first decade of the transition.

The paper is organized as follows. In Section 2, we examine the initial conditions: the tax systems in socialist planned economies, and the enduring legacy of central planning and its influence on CIT tax systems. In Section 3, we review the choice of general reform paradigms for

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<sup>3</sup> For the purpose of this paper, CIT refers to all previous centrally planned or socialist countries in Central and Eastern Europe (CEE) and the former Soviet Union (FSU). Other countries experimenting with transition to a market economy include China, Vietnam, Cambodia, Laos, North Korea, and Myanmar. Cuba is a special case in itself and like in North Korea little reform has been pursued there. The main differences between CITs in CEE and the FSU, and the rest is that the latter group of countries has not simultaneously engaged in political liberalization, maintaining instead a single-party political system. The focus of this paper is on tax reform in CEE and the FSU.

<sup>4</sup> See Martinez-Vazquez and McNab (1999) for an earlier review of tax systems in transitional economies and Ebril and Havrylyshyn (1999) for a more recent review of tax reform in the Former Soviet Union. Background information on the economic conditions and the tax structure of CITs is available from the European Bank for Reconstruction and Development's *Transition Report* (1996, 1999) and the International Bureau of Fiscal Documentation's *Central and Eastern European Tax Directory* (1996, 1999).

policymakers early on in the transition and review the main features of the advice provided by western tax policy experts. In Section 4, we describe the current structure of tax systems in CITs, and particularly focus on the key role played by tax administration. In Section 5, we provide an evaluation of the CIT's tax reform performance and sum up the lessons learned from the tax reform experiment.

## **2. The Initial Conditions: The Tax Systems of Centrally-Planned Economies and Their Legacy**

Most centrally planned economies (CPEs) in Eastern Europe imitated the tax system of the Soviet Union (Bakes, 1991). Tax revenues in CPEs came mostly from profit, turnover, and payroll taxes levied on state-owned enterprises. The private sector was commonly outlawed and property taxes did not exist. The “profit tax,” by far the most important source of revenue, had high and progressive rates and was used to accumulate and centralize resources and to regulate enterprise income.<sup>5</sup> Turnover taxes applied mainly to consumer goods and to some services. These were generally single rate levies differentiated by commodity and sometimes by type of enterprise and were used as a residual wedge between retail and producer prices (Tait, 1988; Gandhi and Mihaljek, 1992). Wage and payroll taxes were withheld at the enterprise level with revenues generally earmarked to fund social expenditures. Individual income taxation was relatively unimportant. Customs tariffs were generally imposed on goods imported from countries outside the Council of Mutual Economic Assistance (CMEA) but typically represented a small portion of total tax revenues; planning authorities preferred quantitative restrictions over nominal tariffs to regulate imports.

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<sup>5</sup>Since goods were not traded at market prices in planned economies, costs and revenues did not reflect scarcity and hence “profit” had a different meaning than in market economies.

Although tax administration was underdeveloped in all CPEs (Tanzi, 1993 and 1999; Balerowicz and Gelb, 1995; Bird, 1999), this reality did not represent a serious handicap because the relatively small number of taxpayers meant that the state could reportedly conduct a 100 percent audit each year to ensure compliance (Kodrzycki and Zolt, 1994). Tax administration and enforcement were substantially facilitated by the ability to track payments through the state banking system and by administratively set prices and wages. Ultimately, the institutional capacity of the tax administration was not a problem because the state could and often did retroactively adjust the structure of taxes and administrative procedures to meet its perceived revenue needs. There was little opposition to otherwise controversial tax measures because the state served a dual role as the owner of enterprises and as the tax collector.

The principles and practices of tax systems under planned socialism have had a lasting impact on the tax systems of CITs. The most salient features of this legacy include:

(i) *An Interventionist Tradition*: Taxes in CPEs were used to raise revenues but also for many other purposes, such as to appropriate surpluses as the owner of capital, affect the allocation of resources, and so on. This tradition has lingered during the transition contributing to the complexity of the tax laws and wide use of tax incentives.

(ii) *Customized Taxes*: Tax liabilities in CPEs were frequently negotiated, which meant there was a lack of systematic relationship between statutory tax bases and actual tax liabilities. Negotiated taxes constituted part of the soft-budget constraint facing firms and it virtually protected them from bankruptcy risk (Gray 1991; Gandhi and Mihaljek, 1992; Kopits and Offerdal, 1994; Kornai, 1986 and 1992; Owens, 1991; and Bahl, 1999). New forms of customized or negotiated taxes, such as tax offsets, which are discussed below, have emerged during the transition.

(iii) *Lack of a Tradition of Voluntary Compliance*: The tax system of CPEs lacked transparency. Often enterprises did not know what other enterprises in similar circumstances paid in taxes<sup>6</sup>. The population at large were neither aware of taxes nor had any perceptions of tax burdens, since very few individuals actually filed tax returns or paid taxes during transactions (Kodrzycki, 1993; Tanzi, 1994). Two fundamental pillars of modern tax systems, voluntary compliance and self-filing, were absent at the start of the transition. Not surprisingly, many citizens, when explicitly taxed for the first time at the beginning of the transition, chose to evade taxes.

(iv) *Absence of Conventional Excess Burdens*: With the prevalence of implicit taxation and restrictions on individual choice and mobility, planned economies for the most part had an absence of conventional tax distortions or excess burdens. Individual taxpayers were mostly not aware of the tax system nor could they make decisions themselves directly in response to the taxes that were explicit (McLure, 1991a, b).<sup>7</sup> This made it more difficult than usual for decision makers in CITs to be sensitive to the potential excess burden losses of distortions and it increased the likelihood of flawed tax design.

(v) *Taxes and Income Redistribution*: Although equality in the distribution of income was, at least nominally, a fundamental objective of CPEs, this objective did not figure prominently in CPE tax policies. Central planners had more direct ways to affect wages but real incomes were far from being equally distributed. It was access to goods and services, not nominal income, that determined an individual's consumption possibilities, and access was always easier for Party

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<sup>6</sup> Implicit taxation, through price and wage setting, was almost as common in CPEs as explicit taxation (Kopits, 1991).

<sup>7</sup> The absence of conventional tax distortion in CPEs did not mean, of course, that these countries escaped economic inefficiencies. In addition to poor decisions in the allocation of resources, central planning eroded incentives to innovate, work, and save (Kornai, 1990), and created incentives for participation in the underground economy and the growth of bribes and other corrupt practices.

members and the Nomenklatura. The tradition of not using the tax system for significant redistributive purposes has continued in the transition.

(vii) *Undeveloped Tax Administration*: The inheritance of an unsophisticated and highly deconcentrated tax administration left CITs at the start of the transition unprepared to enforce taxes with a manifold increase in the number of taxpayers and the abolition of the official payments system.

(vii) *Public Distrust of Government Institutions*: The failure of CPEs to raise general living standards in combination with the privileged status of those in power bred widespread cynicism among the population while at the same time propelling the growth of the unofficial or underground economy. At the start of the transition, a tradition of corrupt governance practices and significant underground economies proved fertile ground for the growth of all forms of tax evasion in CITs (Ickes and Slemrod, 1991; Newcity, 1991).

### **3. The Choice of Tax Reform Approach**

Early on, the prospect of the transition to a market economy raised the question of what the best approach to tax reform should be and which type of tax structure should be adopted. The two basic choices for tax reform, which paralleled those discussed also at that time for overall economic reform, were, first, the adoption of a modern tax system patterned after those in market economies introduced with a “big-bang.” The second choice was a gradual, evolutionary, reform process which would introduce elements of a modern tax system, but would also recognize in the process the lack of administrative and institutional capacity and the need to compromise with less than ideal tax measures to preserve revenues.<sup>8</sup>

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<sup>8</sup> For an argument in favor of the big-bang approach to overall reform see Lipton and Sachs (1990a, 1990b), and for a defense of a gradualist approach see McKinnon (1991) and Hussain and Stern (1993). For a discussion of the choice of strategy for tax reform see OECD (1991a, b), Tanzi (1992), Shome and Escolano (1993), and Go (1994).

Early enthusiasm among CITs for adopting a modern tax system similar to those in western Europe or in North America attracted stern warnings from international experts about the potential risks of adopting such a strategy.<sup>9</sup> These risks ranged from the adoption of troublesome features or errant policies of western systems or the adoption of policies designed for developed market economies with advanced tax administrations, established accounting practices, and enforceable contract law. Western expert advice was solidly in favor of an evolutionary tax reform strategy for CITs due to the institutional weakness of tax administrations, understaffed and undeveloped custom services, rapid decline in importance of the more easily monitored state-owned enterprises, lack of modern business accounting standards and practices and other initial unfavorable conditions.

However, an evolutionary approach to tax reform was not without risks. A slow, more gradual approach to tax reform could make comprehensive tax reform more difficult to achieve as vested interests would emerge with power to slow down or block fundamental reforms. An evolutionary approach could also deprive CITs of the stability and certainty needed to stimulate domestic entrepreneurship and to attract foreign investors. In reality, both of these risks materialized to different degrees in many CITs, as is discussed below.

Western advice for tax reform in CITs concentrated on several themes. First, there was a concern about the need to mitigate the acute revenue problems expected to occur at the beginning of the transition.<sup>10</sup> In particular, selecting taxes with breadth would help reduce the volatility of tax revenues (Cnossen, 1991 and McKinnon, 1991). Second, emphasis was put on the need to develop tax systems that adapted to meet the particular needs and peculiarities of each country in transition (Bird, 1992; Bogetic and Hillman, 1994; McLure 1995a, b). Other than for potential cross-country

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<sup>9</sup> See, for example, McLure (1991b); and Tanzi (1993).

<sup>10</sup> See Owens, 1991; Hussain and Stern, 1993; Kopits and Offerdal, 1994; Tanzi and Shome, 1993.

competitive pressures, CITs were for the most part quite free to follow their own model.<sup>11</sup> Third, the choice of tax instruments would need to explicitly acknowledge the weaknesses in tax administration by selecting taxes that could more easily be enforced (Ickes and Slemrod, 1991) and by incorporating critical aspects of tax administration into the tax laws (Cnossen, 1991; Ickes and Slemrod, 1991; McLure, 1995a; and Tanzi, 1993).

To a large extent, western policy advice coincided on the early introduction of a VAT and excises, the elimination of export taxes and the prevention of high import taxes, and the delayed introduction of a modern western-style global income tax on individuals. For individual income taxation, the advice was to continue using schedular taxes and to introduce or expand withholding at source. There was less consensus on the particular structure of corporate income taxes.

Did CITs follow western advice? The choices of tax reform strategy actually pursued are difficult to summarize because of their diverse content and timing. Perhaps one general assertion that can be made is that CITs that undertook tax reform, almost without exception, focused their efforts on tax policy and, ignoring the advice of western experts, gave low priority to modernizing tax administration and introducing modern accounting practices. Only recently has tax administration reform taken central stage in some CITs.

In tax policy, several CITs in CEE (Hungary, Czech Republic, Poland, Slovenia) and also the Baltic States (Estonia, Latvia and Lithuania) rapidly moved early in the transition to introduce comprehensive tax reform. A powerful objective common to all these countries was their desire for accession to the European Union (EU). These reforms, as we see in more detail in the next section, introduced modern tax systems along the lines of those in place in EU countries but also with individual features reflecting each country's circumstances. Serious tax policy reform in other CEE

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<sup>11</sup> The only pressure to conform was among CIS countries which, as discussed below, had chosen to implement an origin-based VAT for trade among themselves.



countries (Romania, Bulgaria, Albania) and most of the FSU countries did not take place until the middle and last half of the decade, if at all. There were again very diverse experiences. For example, Kazakhstan was the first among FSU countries (other than the Baltic States) to introduce a comprehensive and modern tax code in 1995 (McLure, 1998). On the other hand, Russia failed in 1997 and again in 1998 to introduce a comprehensive tax code and still lacks today an adequate tax system (Martinez-Vazquez and Wallace, 1999). Over the last three years, Georgia, Uzbekistan, and Tajikistan have adopted comprehensive new tax codes (Ebrill and Havrylyshyn, 1999). Other FSU and CEE countries have also modernized their tax structures in a piecemeal fashion in recent years. The noticeable laggards in tax policy reform are Belarus and Turkmenistan. However, progress in tax policy reform has not been steady. For example, in an apparent burst of tax competition, several CEE countries (Poland, Hungary, Czech Republic) have reintroduced numerous tax holidays and exemptions. Similar backsliding from broad and simplified rules has taken place in Kazakhstan and Georgia.

There are no easily identifiable general reasons to explain why tax reform has moved faster in some CITs than others. Significant tax reform tended to occur in those countries also undergoing privatization and all other kinds of economic reforms. Of course, politics played a role, in particular the priority and support given to tax reform by the top authorities and whether or not governments had a majority or solid support in parliament. In CEE countries and also the Baltic States, the pull of EU accession seems to have acted as a catalyst for reform. In the cases of Kazakhstan and Georgia, there were lengthy discussions and preparations with very active contributions in technical assistance from foreign advisors. In Russia, although there was also foreign technical assistance, there was less of a consensual and broad support approach to tax reform. With the passage of time, vested interests, including the new “oligarchs” and some regional governments, in combination with

the communist opposition in parliament were enough to block reform. But overall, though with fits and starts, significant progress has been made in tax policy reform among CITs. We now turn to the main features of the CITs' tax systems and examine the lack of progress in the reform and modernization of tax administration.

#### **4. The Current Structure of Tax Systems**

The current structure of tax systems in CITs largely resembles, at least on the surface, the structure of tax systems in western countries with reliance on: (i) direct taxes including the personal income tax (PIT), corporate income tax or enterprise profit tax (EPT), and payroll or social security taxes; and (ii) indirect taxes, including a VAT, excises, and a customs tariff. However, property taxes in CITs do not play a significant role as they do in many western countries. In this section, we look at the reform status of the major taxes, the assignment of revenue sources among the different levels of government, and the process of modernization of tax administration.

*Enterprise Profit Tax.* Hungary and Poland were the first two countries to reform their Soviet-inspired enterprise profit tax (EPT) in 1989. The reform of the EPT has been particularly slow and tortuous, aided perhaps by the fact that the taxation of enterprise profits raises an array of complex issues, such as the treatment of inflation, for which there are no best practice or standard answers. The two most salient features of enterprise income taxation in CITs have been, first, the tendency to overstate taxable profit by restricting deductible expenses, and second, the use of the tax laws to promote or guide investment activities through tax incentives and holidays. During the transition, the revenue yield of the EPT has steadily decreased in relative importance vis-a-vis the PIT, payroll taxes, and the VAT.

Table 1 presents a review of the current state of income taxation in the CITs. Currently, the general rates of the enterprise profit tax are moderate and often below those in western tax systems.<sup>12</sup>

Out of 26 CITs, fifteen have a rates of 30 percent or higher. The highest basic rate is 40 percent for the Slovak Republic and the lowest 18 percent in Hungary and 13 percent in Macedonia. In Russia, the current basic rate is 30 percent.<sup>13</sup> These rates represent significant changes from the enterprise profit taxes in CPEs, which had rates as high as 85 percent, and also the relatively high, often multiple, rates that prevailed during the early years of the transition. The trend over the past several years in CITs has been toward the consolidation of rates into a lower basic or general rate.

The calculation of the tax base for the EPT has undergone profound transformations in CITs. Early in that transition, it was common to limit all kinds of deductions from enterprise revenues including wages, capital depreciation and interest. In fact, during the first years of the transition in many CITs the taxation of enterprise income included various forms of “excess wage taxes” (EWTs).<sup>14</sup> Typically, a rate similar to the EPT rate was levied on the payroll for wages over some minimum legislated wages. For these reasons the CIT was known in Russia and other FSU countries as the enterprise income (rather than profit) tax. Considerable progress has been made in most CITs in the latter half of the decade to allow for the deduction of costs incurred in the generation of taxable income. However, some CITs still disallow or limit the deduction of expenses conventionally allowed in western tax systems such as interest on long-term loans, certain capital expenditures and labor costs, expenses in research and development, advertising, and expenses in environmental protection. The norm among CITs is to allow the carry-forward of losses for a period

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<sup>12</sup> See, for example, International Bureau of Fiscal Documentation (1999).

<sup>13</sup> Russia and several other FSU countries employ higher special rates for gambling activities. Many CITs have also introduced presumptive taxation of small businesses (Ebril and Havrylyshyn, 1999; Mikesell, 1999).

<sup>14</sup> The EWTs were said to prevent the decapitalization of enterprises but mainly, they were relatively easy to administer and generated significant revenues. Currently only Belarus and Turkmenistan use some form of a EWT.

of 5 years but none of the CIT enterprise profit taxes provides for the carry-back of losses.<sup>15</sup> The most common methods of depreciation allowed in CITs are straight-line and declining-balance methods at historic costs with no adjustments for inflation.<sup>16</sup> These represent also significant progress over unconventional measures used early in the transition.<sup>17</sup>

The EPT in many CITs remains saddled with tax incentives, holidays, and at times, ad hoc, special treatment provisions.<sup>18</sup> The incentives have included reinvestment allowances as a share of profits (at times up to 100 percent) for particular sectors (most often agricultural production, but also construction and mineral extraction) or geographic areas, and special incentives designed for foreign investors. Some of these incentives have been eliminated in recent years but progress often has been followed by the emergence of new schemes.

*Personal Income Tax:* Hungary in 1988 and Poland in 1992 were again first in line for the reform of this tax. Many other CITs reformed theirs in 1993 and 1994.<sup>19</sup> The PIT has generally continued to grow in relative revenue importance and, on average, represents the third most important revenue source for CITs behind social security taxes and the VAT. As in the case of most income taxes in the rest of the world, CITs adopted neither a full income tax base nor a consumption

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<sup>15</sup> The only exception is Hungary which allows a carry-back for the agricultural sector. Several countries (Belarus, Lithuania, Moldova, Turkmenistan, and Uzbekistan) have no carry-forward provisions, while Azerbaijan and Tajikistan limit carry-forward provisions to enterprises with foreign participation.

<sup>16</sup> Historical costs were difficult to measure properly at the start of the transition due to the lack of relevant market prices for capital goods. Kazakhstan adopted in 1995 a pooled asset account system and Ukraine recently introduced the indexation of assets for inflation.

<sup>17</sup> See, for example, Shome and Escolano (1993).

<sup>18</sup> For example, presidential decrees were often used in the Russian Federation to grant tax benefits to entire sectors (e.g., the energy sector) and specific individual enterprises (e.g., the Zil automobile company in Moscow) (OECD, 1995a).

<sup>19</sup> The inspiration for the new legislation came from multiple sources, including Hussey and Lubick's *Basic World Tax Code* (1992).

base, but rather a hybrid base.<sup>20</sup> Currently, most CITs exempt interest income or tax it at a lower rate,<sup>21</sup> and fewer of them exempt dividends and capital gains. Although some CITs adopted a global personal income tax similar to that existing in most OECD countries, the lack of a well developed tax administration has induced most of them to rely instead on a schedular structure.<sup>22</sup> A final withholding schedular tax for salaried employees with no other source of income is the norm and a good share of CITs also use final withholding schedular taxes for several forms of capital income.<sup>23</sup>

In addition to some of the capital income, the typical base of the individual income tax in CITs includes all types of labor income. In particular, it is common to include in the base fringe benefits, bonuses, allowances and other forms of non-cash income. These forms of remuneration historically have been more common in CITs than in market economies.<sup>24</sup> Practically all CITs allow for personal and dependent deductions and exempt income from pensions.<sup>25</sup>

Most CITs have a mildly progressive tax rate schedule. However, the trend over the transition has been toward lower maximum tax rates and a smaller number of tax brackets. Earlier in the transition, for example, Romania had 15 brackets and Bulgaria 8. However, Estonia has

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<sup>20</sup> See McLure (1992) and McLure and Zodrow (1996). To the extent that a consumption-based income tax provides more incentives to savings and investment, the choice of a consumption base would be more desirable in CITs because of their much higher needs for national savings and capital accumulation. The only CIT that attempted the adoption of a consumption base was Croatia in 1994. Although the PIT was consumption based, the right complement for the taxation of enterprise income, a cash-flow tax, was never adopted. See Martinez-Vazquez and Boex (1996).

<sup>21</sup> Kazakhstan, Macedonia, and Yugoslavia tax interest as ordinary income.

<sup>22</sup> See, for example McLure (1991a) and Tanzi (1991).

<sup>23</sup> For example, final withholding taxes on dividends are used in Albania, Belarus, Bulgaria, Czech Republic, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Lithuania, Poland, Romania, Slovakia, Turkmenistan, Ukraine and Uzbekistan.

<sup>24</sup> A considerable part of personal income in CPEs was paid in fringe benefits. High payroll taxes and excess wage taxes have provided incentives during the transition for this form of compensation.

<sup>25</sup> Typically, contributions to a pension are not allowed as a deduction.

always had a single rate and Croatia and Latvia two rates. Currently, the most common top marginal rate in CITs is 40 percent, but it is as high as 50 percent in Slovenia and as low as 20 percent in Georgia. As a rule PIT rates are higher than EPT rates.<sup>26</sup> None of the CITs has explicit adjustments for inflation in the individual income tax, although about one-third of them define tax brackets in terms of minimum salaries or personal allowances which may be adjusted for inflation, but seldom are for tax purposes alone.

*Payroll Taxes:* Payroll taxes and social fund contributions are among the most important sources of revenue in CITs. Tax rates have been relatively high in comparison to those in OECD countries (Tanzi, 1994). Three countries (Belarus, Bulgaria, and the Slovak Republic) have currently overall payroll tax rates of 50 percent or over. Lithuania and Turkmenistan have the lowest rate of 31 percent. The high payroll tax rates have pushed many enterprises underground, introduced anti-labor biases in the choice of inputs, and contributed to the uncompetitiveness of CITs in international markets.

With only the exception of the former Yugoslavia, CIT social security funds at the start of the transition were almost exclusively employer financed. This legacy has proved difficult to overcome. Many CITs still only require a token employee contribution to the social security and pension system.<sup>27</sup> Although it does not change the final incidence of the social security tax, the introduction of employee contributions provides increased transparency and incentives for better

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<sup>26</sup> The issue of integration of enterprise and individual income taxes to avoid double taxation of enterprise income has been approached in CITs in similar ways to those used in western countries, including the “classical system” and relief by lower rates or exemption of dividends. Armenia, Croatia, and Latvia currently exempt dividends.

<sup>27</sup> Azerbaijan, Belarus, Bulgaria, Estonia, Georgia, Kazakstan, Lithuania, Macedonia, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan require less than a 5% employee contribution to the unemployment, pension, health, and disability social security funds.

oversight of the social security funds. Until recently, CIT's have not moved significantly in the reform of payroll taxation; however, one should expect more reform initiatives in the near future.<sup>28</sup>

*Value Added Tax (VAT):* At the start of the transition, the most immediate task in the area of indirect taxation was to replace the complex turnover taxes prevalent in CPEs. The basic choice was between a single stage retail sales tax and a conventional invoice-credit value-added tax.<sup>29</sup> Hungary, Russia, and the remainder of the FSU were among those CITs that opted for a VAT early in the transition period, with other CITs adopting an intermediate strategy of simplifying and refining their existing turnover taxes for a number of years, in preparation for the future introduction of a VAT.

Table 2 presents a review of the current state of indirect taxation in the CITs. Currently all CITs in Eastern Europe and the FSU have a VAT and in most of these countries the VAT is the single most important source of tax revenue. The only CIT without a VAT is Yugoslavia (Serbia and Montenegro). Two basic VAT models were originally followed. The first was the Soviet model, introduced in December 1991, which was rapidly adopted in all the Commonwealth of Independent States (CIS) countries.<sup>30</sup> The second was the European Union (EU) model which was adopted, with variations, in CEE and the Baltic states. Over the transition, as we discuss below, most FSU countries have continued to convert their VATs to the EU model.<sup>31</sup>

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<sup>28</sup> The most recent reforms, however, appear to be headed in the wrong direction. In 1999, Kazakhstan abolished all the social security extra-budgetary funds and reassigned the payroll tax to local governments. In January 2000, Russia introduced an increase in rates for mandatory social insurance up to 10.7 percent which goes on top of the current combined rate of 39.5 percent.

<sup>29</sup> See Shome and Escolano (1993), Summers and Sunley (1995), and Cnossen (1998).

<sup>30</sup> The Russian VAT model is reviewed in Summers and Sunley (1995) and Shome and Escolano (1993). For a definition of this term and others see the International Bureau for Fiscal Documentation's *International Tax Glossary* (1996).

<sup>31</sup> See International Bureau for Fiscal Documentation (1999) and Ebrill and Havrylyshyn (1999).

The Soviet model VAT had very few good features other than a single rate (albeit high at 28 percent) and a fairly broad base covering most goods and services.<sup>32</sup> On the minus side, the Soviet model VAT presented several significant problems. First, the accounting of tax liabilities from sales was on a cash basis, which made it basically incompatible with the effective application of the invoice-credit method. Second, the invoice-credit method was only used for calculating tax liabilities at the manufacturing level. Liabilities at the wholesale and retail levels, and in most service sectors, were calculated using a subtraction method VAT, on the basis of taxpayers' gross margins.<sup>33</sup> Third, the original VAT denied credits for the VAT paid on capital inputs, which destroyed the consumption basis of the VAT. Finally, all CIS countries applied the origin principle for trade among themselves. Exports to CIS countries were treated as domestic sales so they were subject to tax, while imports from CIS countries were exempt from tax. Originally, imports from all other (non-CIS) countries were not subject to VAT but quite quickly this was reversed and the destination principle was applied to these transactions.

Currently, all CIS countries have a general rate of 20 percent dictated by the fact that most of these countries still apply the origin method for trade among themselves and that Russia, the main trade partner in the CIS, has chosen that rate. The general 20 percent rate is the single rate for all CIS countries except Russia and Belarus, which also have a reduced rate of 10 percent for food and medicines and other protected products, and Uzbekistan which has a reduced rate of 15 percent on

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<sup>32</sup> The choice of this high rate of 28 percent was driven by the short-term objective of matching the revenues collected with the old turnover tax.

<sup>33</sup> At least for some time, Belarus used a subtraction method VAT at all levels (Bird, 1995). Under the subtraction method, the cost of all business inputs are deducted from all output sales receipts and the applicable VAT rate is multiplied by the difference to obtain the liability. The subtraction method differs from invoice-credit method in that in the latter the firm applies the VAT rate to total sales and credits against this liability the VAT paid by its suppliers. The gross margin method is, in theory, related to the firm's mark-up on sales. However, in practice, the margin was a percentage defined in advanced and was considered a leftover from the Soviet system. VAT liability under the gross margin method was obtained by multiplying the margin by the tax-inclusive rate of VAT. See Summers and Sunley (1995).



similar products. The original broad coverage of the VAT in CIS countries was soon eroded by a proliferation of exemptions and special treatments, leading to lower revenues and to increased compliance and administration costs. In the last several years, there has been some progress toward broadening the coverage of the VAT but often followed by reversals (Ebrill and Havrilyshyn, 1999).

Some progress has been made in reforming the other original features of the VAT in CIS countries but this progress has been uneven and significant problems remain. Kazakhstan and Kyrgyzstan have been the only two countries to shift to an accrual basis for the accounting of tax liabilities from sales. In Russia the switch to accrual accounting had been proposed in the draft Tax Code of 1997 and was subsequently dropped in the new draft Tax Code presented to the Duma in 1998 and, so far, no fundamental action has been taken for reforming the VAT.<sup>34</sup> The use of the credit-invoice method only at the manufacturing level is still standard, although recently Armenia, Azerbaijan and Ukraine have switched the wholesale and retail sectors from the gross-margin to the credit-invoice method. Russia is scheduled to switch all sectors to the credit-invoice method in January 2000. There has been clearer progress in other areas. All CIS countries now subject imports to VAT and allow full credit for the VAT paid on capital inputs. However, in most CITs refunds or credits for VAT paid on imports are not paid on a timely basis, if paid at all. The use of the origin principle is still the rule for international trade with other CIS countries but there has been some movement away from it. In particular, Moldova and Armenia have adopted the destination principle for all international trade and Georgia has done the same except for trade with Russia.<sup>35</sup>

The non-CIS Eastern European CITs adopted a European credit-invoice VAT early in the transition process. The desire to join the EU at a future date had a strong influence on the choice

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<sup>34</sup> See Martinez-Vazquez and Wallace (1999).

<sup>35</sup> Not unexpectedly, the use of the origin principle has caused friction among CIS countries. Apparently, Belarus has been taxing both imports from and exports to Ukraine (Ebrill and Havrilyshyn, 1999). Russia applied a destination principle for trade with Ukraine from August 1996 to December 1997.

of VAT structure. Hungary introduced a VAT in 1988 followed by Poland and Romania in 1993. The remainder of the non-CIS Eastern European CITs followed soon thereafter with Slovenia being the last to adopt the VAT in July 1999. In the early part of the decade, the countries in this group fell into two general categories, two-rate VAT countries (Czech Republic, Hungary, Romania, Slovak Republic, and Lithuania) and single-rate VAT countries (Bulgaria, Estonia, and Latvia). Poland was the sole exception with a VAT that had three rates. Over the latter half of the decade, there has been some reform, with the introduction of a single rate VAT in Croatia, the elimination of multiple VAT rates in Lithuania, and the reduction of the number of VAT rates in Poland from three to two. The current choice of general rate (18 percent for the Baltic states and 22 percent as the norm for the rest) places these countries within the higher tier of VAT rates compared to their Western European counterparts. The use of multiple rates with a lower rate for “necessities,” helped many CEE countries to keep wide coverage early in the transition. More recently, there has been a trend in these countries to increase the number of exemptions.

*Excise taxes:* Most CITs have introduced separate western-type excise taxes on tobacco, alcoholic beverages, and petroleum products. In some CITs the list of excisable commodities is augmented by variable lists of “luxury goods.” Recent reforms have been aimed at simplifying and reducing the number of excises and equalizing rates for domestic production and imported commodities. There has also been a trend toward the equalization of rates among neighboring countries under the pressure of cross-border contraband especially among FSU neighbors where borders tend to be more porous. Tax rates have been on the increase but are usually below international levels. Both ad-valorem and specific rates are used but the recent reforms have been toward the conversion of ad-valorem rates into specific rates, mostly to combat different forms of tax evasion. Because it is quantity consumed rather than value that generates the negative

externalities associated with excisable commodities, specific rates may also be more effective in reducing externalities than ad valorem rates. Besides being more regressive, the main problem with specific rates has been the lack of adjustment for inflation and the consequent erosion of revenues. Russia has addressed this problem by indexing some of the rates for inflation. Other CITs have chosen to express their specific rates in foreign currency, such as in US dollars (Kyrgyzstan) or German marks (Croatia).

*Taxes on international trade:* Customs duties were not an important part of the revenue systems of CPEs. By the middle of the decade all CITs had adopted a new customs tariff. The norm in Central and Eastern Europe CITs has been to introduce modestly protective tariffs with low rate dispersion, with an eye to complying over time with EU directives. Among CIS countries, higher tariffs and somewhat wider dispersion than in CEE have been more common. This has been in response to pressures for protecting domestic activities but also as a new-found additional source of tax revenue under frequent fiscal crises. The trend in recent reforms of the customs tariff in the CIS countries has been toward lowering the dispersion of rates (Ebrill and Havrylyshyn, 1999). Although export taxes, especially on natural resources, were common in the early years of the transition, currently very few CITs use them and they tend not to be significant. Export taxes, however, have reappeared temporarily during times of fiscal crisis.

*Subnational taxes and fiscal decentralization:* Practically without exception CITs have embarked, to a lesser or greater extent, upon the process of decentralizing their intergovernmental fiscal relations.<sup>36</sup> The assignment of revenues to different levels of government is a key element of any decentralization process. Revenue sharing, as opposed to exclusive assignment of taxes, is by far the dominant source of subnational finance in practically all CITs. The main taxes shared by the

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<sup>36</sup> See Bird, Ebel, and Wallich (1995) and Wetzel and Dunn (1999).

center with subnational governments on a derivation basis are the personal income tax, corporate income tax, excises, and in many cases the VAT. Two modes of revenue sharing have been adopted. The traditional or “regulating” method still used in many FSU countries uses different sharing rates by tax and by subnational government, which may change in every annual budget. This method provides fiscal flexibility and complete freedom to equalize or “regulate” revenues, but causes budget unpredictability and creates perverse incentives toward revenue mobilization at the subnational level. Central authorities using the ‘regulating’ approach have routinely decreased sharing rates in order to claw back “excessive” revenues. Other CITs in CEE and also Russia, Kazakhstan and Kyrgyzstan have adopted uniform (across subnational governments) and stable (over several years) sharing rates.

Revenue autonomy at the subnational level, or the ability to increase revenues (by changing rates or bases, or by introducing new taxes), has been slowly introduced but tax autonomy still remains very low. Traditionally (from the previous regime) a number of taxes have been assigned as “own revenues” in CITs but this is often a misnomer because the structure of the tax is entirely determined by the center. Limited revenue autonomy has been granted often in the form of some choice of rates for small taxes, such as the land rental tax, or “nuisance” taxes and user charges.<sup>37</sup> Several CITs have experimented with more meaningful forms of revenue autonomy. For example, Russia and Kyrgyzstan have introduced subnational sales taxes with optional maximum rates.<sup>38</sup> Several other countries in CEE are in the process of converting traditional property taxes on land,

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<sup>37</sup> In practice, user charges have often been limited due to political considerations (e.g., protecting the poor) and administrative constraints (e.g., individual metering in multi-unit buildings is not always feasible).

<sup>38</sup> Although they can provide meaningful revenue autonomy at the subnational level, the introduction of a sales tax when a national VAT already exists can create substantial compliance and administrative problems.

buildings and enterprise assets into western-style real estate property taxes.<sup>39</sup> Croatia is the only CIT that has introduced a personal income surtax at the subnational level and in other countries, such as Russia and Ukraine, revenue sharing for the corporate income tax surtax is in the form of an optional surtax up to a maximum rate.

*The Modernization and Reform of Tax Administration:* The modernization and reform of tax administration has lagged, at times considerably, behind the drive to modernize tax policy in CITs. Although with hindsight not a surprise, during the first decade of the transition it has proven much easier to reform the tax laws than to build, basically from scratch, an effective administration to collect and enforce taxes.

Often with support from international organizations and bilateral aid programs, some progress has been made in the modernization of tax administration in CITs in the form of enacting new tax administration laws, explicitly addressing taxpayer rights in the tax laws, and rationalizing the structure and organization of the tax administration.<sup>40</sup> However, significant tax administration problems remain in many CITs. Weak administrative capacity encompasses a variety of issues:

- inability to register and process large numbers of new taxpayers
- deficient collection methods
- lack of capacity to conduct full-field audits or use third-party information
- simplistic audit plans and rare use of audit selection programs
- lack of sufficiently trained personnel to detect sophisticated tax evasion techniques such as transfer pricing
- incipient or non-existent taxpayer services
- inadequate training
- insufficient resources to retain skilled personnel and build adequate information systems

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<sup>39</sup> This process has been slow. These difficulties have been dramatized in Russia's pilot project in the cities of Tver and Novgorod over the past four years. See Martinez-Vazquez and Wallace (1999).

<sup>40</sup> For example, several FUS countries have changed to or are planning to change to a functional organization structure, including Azerbaijan, Estonia, Georgia, Latvia, Lithuania, Tajikistan, and Ukraine (Ebril and Havrylyshyn, 1999).

- often overstaffed local offices and understaffed and weak central headquarters.<sup>41</sup>

These deficiencies have translated into high levels of tax evasion by international standards, a significant growth in tax arrears, and an overall lackluster revenue performance. In CITs where tax evasion has been studied, compliance rates of 50 percent or lower are not uncommon.<sup>42</sup> Tax arrears, or late and delinquent payment of tax liabilities, are a pervasive phenomenon, especially in FSU countries. For example, at the end of 1998, accumulated tax arrears in Russia were close to total tax collections for that same year.

Building an effective tax administration is a difficult task anywhere, but the question is, why has it been so particularly difficult in CITs? Some of the fundamental problems confronting the modernization of tax administration in CITs have been inherited, but some other problems have been self-inflicted by the tax administrations themselves, or have been caused by specific central government policies. The initial conditions, as we have seen, of a lack of tradition with voluntary tax compliance, a culture of mistrust toward government, citizen survival by flaunting government rules, and undeveloped administration practices under planned socialism, did present the new tax administrations in CITs with unusual handicaps.<sup>43</sup> A different, but equally powerful, inherited handicap for tax administrations, was the widespread use of barter among enterprises, which in many CITs have continued to operate to the present with negative value-added in what has been

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<sup>41</sup> Although our discussion focuses on tax administration, similar problems involving classification and valuation issues have arisen in the creation of customs administration, in most CITs also from scratch. Customs administrations play an important role because they are in charge of collecting VAT and excises on imports in addition to collecting the customs tariff.

<sup>42</sup> See Martinez-Vazquez and Wallace (1999 and forthcoming), Anderson and Carasciuc (1999) and Karnite and Dovladbekova (1995).

<sup>43</sup> See Kornai (1990), Tanzi (1994), Bogetic and Hillman (1994), Summers and Sunley (1995) and McLure (1995b).

called the “virtual economy.”<sup>44</sup> This is especially true in the former FSU. Of course, barter transactions are much harder to tax than monetary transactions.

At the same time the new tax administrations made their own jobs more difficult in several ways. Many CITs still employ the practice of “assisted filing.” That is, the taxpayer and tax administrator fill out and review the tax return together, a practice that diverts scarce resources from audit and collections activities and only adds to taxpayer compliance costs, often much higher in CITs than in other countries.<sup>45</sup> These higher compliance costs take a variety of forms: taxpayers having to wait for hours in line outside with sub-zero temperatures to pay their taxes, taxpayers having to pay for forms and instructions which are routinely not available, or filing procedures that are complex and vague and continuously changing.<sup>46</sup> Tax administrations in CITs have been slow to learn the lesson now internalized by most western tax administrations that taxpayer services are more effective in increasing compliance than the threat of enforcement actions. The prejudgement that all taxpayers are potentially criminals predisposes tax administrations in CITs to call in the “tax police” to solve issues of compliance and erodes voluntary compliance (Bird, 1999). High levels of corruption among tax administration officials continue to have a demoralizing effect on taxpayers and lead legislators to impose limitations and restrictions on tax administration activities that hinder the effectiveness of ordinary tax enforcement measures.<sup>47</sup> Some tax administrations in CITs have

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<sup>44</sup> Besides bartering with each other, survival in the non-cash economy is aided by the enterprises paying for energy and transportation services, and taxes (all of which are government controlled transactions) through overvalued prices for their commodities. See Karpov (1997) and Gaddy and Ickes (1998).

<sup>45</sup> This is supported by a number of surveys of taxpayers. See McLure (1995b) for surveys in Poland, Hungary, and the Czech Republic, and de Melo and Ofer (1994) for Russia.

<sup>46</sup> Bird (1999) notes that the VAT form in the UK was recently reduced to one page while Poland in 1995 increased the number of items on the VAT form from 61 to 105 and failed to include instructions on how to fill out the form.

<sup>47</sup> For example, under the recently approved Part I of the Russian Tax Code, the tax administration will have to go to court to collect most tax penalties.

also made their jobs more difficult by granting periodic tax amnesties. For example, the tax administration in Russia offered four tax amnesties to reduce the amount of accumulated tax arrears between 1993 and 1999, despite hard evidence that arrears worsen every time an amnesty was implemented because taxpayers built up expectations that the new arrears would be forgiven in the future.<sup>48</sup>

Specific central government policies in many CITs have made the task of tax administration much harder than it should be. Rapid change and instability of tax laws has been the norm in many CITs.<sup>49</sup> This has confused tax administrators and taxpayers alike, and created opportunities for tax evasion and avoidance.<sup>50</sup> Often, central governments have introduced significant changes in tax legislation without first consulting with the tax administration about their enforcement feasibility or first giving the tax administration sufficient time for preparation and education of taxpayers. Central governments in many CITs have failed to see the key importance of tax administration and have also failed routinely to budget enough resources for training, equipment, and wages to be able to attract and retain qualified personnel. In addition, there has often been a lack of political commitment at the highest levels of government to the task of tax administration reform, despite the fact that the top job has remained highly politicized with the upper staff subject to a high degree of turnover (Ebrill and Havrylyshyn, 1999).

Perhaps the most egregious example of damage inflicted by central government policies on tax administration practice and effectiveness has been the acceptance and encouragement by many

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<sup>48</sup> See Ivanova and Wyplosz (1999) and Alm et al. (2000).

<sup>49</sup> The scope and frequency of changes to the tax system cannot be accurately measured by main reforms. Frequently, decrees, administrative orders and instructions are used to modify the tax code. For example, Khankevich (1996) reported 10 major structural changes and over 100 modifications to the Belarusian tax system between 1992 and 1996.

<sup>50</sup> The uncertainty associated with the instability of the tax laws has probably discouraged investment, especially by foreign companies (Riordan and McLure, 1993 and Khankevich 1996).



CIT governments (Russia, Ukraine, Kazakhstan and many other FSU countries) of the practice of tax offsets.<sup>51</sup> These are mutual settlements between enterprises in tax arrears and the government that carries budget arrears (late or non-payment) to suppliers, often public utilities in the energy sector. A key feature of tax offsets is that budget officials can manipulate and overstate the value of budget arrears owed to suppliers. This becomes a powerful incentive for all firms, profitable or not, to increase arrears and to pay taxes through mutual offsets. Tax collections in cash or “live” money, as opposed to tax offsets and other non-monetary forms of payment, constitute a small fraction of tax collections in many FSU countries. Budget officials also have their own incentives for using tax offsets because they are the means to by-pass of legislative oversight, increase particular expenditures, and give the impression of better balanced budgets. However, tax offsets distort public expenditure priorities because enterprises often settle tax liabilities by providing low priority budget items. More significantly, the practice of tax offsets allows authorities to customize tax liabilities for individual taxpayers, a practice not very different from what was done in the previous regime, and opens the door to graft and corruption. This raiding of the “commons” by individual budget agencies has contributed to the erosion of real revenues and to the break-down of tax discipline. The importance of tax offsets in overall revenues is difficult to gauge but in some CITs could have been as high as half of all tax revenues at the peak of their use during 1996-1998. More recently the use of tax offsets in CITs in the FSU has declined but by no means disappeared.

The transition to market economies and the reform of other areas of the public sector have presented tax administrations in CITs with several additional dilemmas. The first is whether or not to create separate regional and local government tax administrations. Tax administration used to be a local and regional function in most CPEs. Early in the transition CITs nationalized and

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<sup>51</sup> See Pinto, Debrentsov, and Morosov (2000) for a discussion of the Russian case.

centralized tax services, although in practice, if not *de jure*, the system of dual subordination, where tax administrators answered to central or federal authorities and to local authorities, has remained in many CITs.<sup>52</sup> This has created problems for the central authorities in some cases, when local governments are able to pressure tax administrators to ensure that local governments are the first to receive shared revenues, or to go easy on enterprises deemed important by the local authorities.<sup>53</sup> A different view, and often a complaint of local and regional officials, is that the national tax service has much less of an incentive to allocate scarce resources to the collection of local taxes.<sup>54</sup> Second, it has been quite common in CITs to create a tax police as an organization parallel to the tax administration, charged with the investigation of tax fraud but also of other illegal activities such as illicit hard currency dealings.<sup>55</sup> Although there is a strong need for improved tax enforcement, the existence of the tax police has duplicated many of the regular tax administration functions and it has contributed to the perception of arbitrary and harsh enforcement and to the undermining of voluntary compliance. The third dilemma is whether or not to entrust the regular tax administration with the collection of social security contributions. This issue has gained relevance because many CITs are also struggling with decreasing compliance rates for social security contributions or payroll

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<sup>52</sup> There are several reasons for this, including the fact that local authorities may provide housing and other benefits to local tax administrators.

<sup>53</sup> In Russia and other CIS countries, taxpayers still write separate checks to each level of government sharing revenues of a particular tax. The practice endures because subnational governments mistrust the central government's willingness and ability to hand over funds once it has them.

<sup>54</sup> These issues have been discussed frequently in the literature on intergovernmental fiscal relations in CITs. See Bird, 1995; McLure et al., 1999; and Wallich 1994. Whether central administrations devote adequate resources to the collection of subnational taxes will become more important as subnational government gain tax autonomy. Down the road subnational governments will need to start developing their own tax administrations but clearly not all subnational governments in CITs are equipped to administer even the simplest taxes. Incentive compatible contracts between local governments and central tax administration may be able to take care of the problem but this approach has yet to be tested.

<sup>55</sup> In some CITs this organization has been staffed by the former secret police as part of an entirely separate organization attached to the tax administration but with separate status and rules and regulations (Bird and Tsiopolous, 1994 and Martinez-Vazquez and Boex, 1996).

taxes. Consolidation could bring potential savings but it also raises concerns about the lack of incentives to collect non-central government revenues.

## **5. Summing up: Performance, Lessons, and Recommendations**

The past decade of fiscal reform in CITs has provided a remarkable laboratory in tax policy design and practice. Although the diversity of experiences and countries involved make it hard to draw comparisons and general conclusions, we attempt, in this section, to gauge the performance of CITs in the transitional tax reform experiment. We conclude by extracting several lessons from the first decade of reform and offering several recommendations.

Three different approaches can be taken to measure performance. First, we can ask whether the new tax systems comply with the basic principles in normative tax theory.<sup>56</sup> In light of certain of the applicable normative principles, some progress has been made in CITs' tax systems.<sup>57</sup> For example, the taxation of intermediate goods has, for the most part, been discontinued; the VAT has been universally adopted as the main consumption tax; progress was made on treating imported and domestic goods alike; and excises have been largely adopted with the objective of alleviating negative externalities generated by the consumption of alcohol, tobacco, and petroleum products. However, as we have seen, CITs' tax systems still raise revenues with significantly more distortions than are necessary, by providing, for example, tax holidays and other numerous tax incentives, or by disallowing as deductions ordinary business expenses.

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<sup>56</sup> See, for example, Newbery and Stern (1987).

<sup>57</sup> Some normative principles of taxation have limited value for tax design because they either require information that is practically not available, such as taxing more heavily goods that are complements with leisure, or because they ignore institutional or tax administration constraints, such as the use of income taxes that are global in nature.

A second approach to measure tax reform performance is to ask whether CITs' tax systems have been able to raise adequate tax revenues,<sup>58</sup> and whether they have done so with a fair distribution of tax burdens among income groups.<sup>59</sup> Table 3 shows CITs' revenues as percent of GDP for 1993 to 1998. Tax revenues in all CITs declined significantly in the initial transitional slump (Citrin and Lahiri, 1995 and Hemming et al., 1995). But in general, CEE countries and the Baltic states, which moved sooner to reform their tax systems and where tax reforms went deeper, were better able to maintain revenues or to increase them *vis-a-vis* GDP. What is an adequate level of revenues depends ultimately on how much income a country decides to spend on public goods and services vis-a-vis private consumption, and there is, of course, no uniform or absolute standard for this division. There are two alternate approaches to examine the adequacy of revenues. The first is to make international comparisons. With the possible exceptions of some CITs, such as Georgia, Kazakhstan, and Tajikistan, revenues as percent of GDP are not lower in these countries than in other countries with similar levels of income. In fact, as is the case of most CEE countries, revenues as percent of GDP would appear to be higher than in other countries of similar incomes. The second approach to examining revenue adequacy is to look at the balance between overall revenues and expenditures. Table 4 shows the general government deficit (surplus) as percent of GDP for CITs in 1992 and 1998. With a few exceptions, the general government deficit decreased significantly during the transition. However, the general persistence of government deficits could be taken as a

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<sup>58</sup> Several important caveats apply to the relationship between tax policy reform and revenue performance. The impact of tax policy reform on revenue performance may emerge with long and variable lags. Tax administration is as responsible for revenue performance as is tax policy, if not more so. Revenue performance can also be affected by economic factors. For example, some CITs were more affected than others by the collapse of economic activity in sectors emphasized in the former regime, and the geographical distribution of resources, in particular oil, is very uneven. A drop in revenues can also be a conscious policy choice for the government to take a less active role in the economy.

<sup>59</sup> There are no universally accepted standards for equity in the distribution of tax burdens. The closest thing would be some mild progressivity, or at least the absence of regressivity, in the vertical distribution of tax burdens and the equal horizontal treatment of taxpayers in terms of income.

sign of revenue inadequacy of CITs' tax systems. The question of whether CITs' tax systems have raised revenues in a fair manner is more difficult to address. Most of these countries have experienced significant increases in poverty and income inequality during the transition (EBRD, 1999). Table 4 shows the Gini coefficient for earnings and the share of population under the international poverty line of US \$4 per day. Both inequality and poverty levels tend to be much more pronounced in the FSU than in CEE. To determine whether the tax systems have contributed to or offset these trends requires data and analysis well beyond the scope of this paper. For the case of Russia, the vertical distribution of tax burdens under conventional assumptions on the final incidence of taxes is proportional or mildly progressive, although strongly regressive for the poorest income groups.<sup>60</sup> There is no general information either on the performance in terms of horizontal equity in CITs but several features of these tax systems, such as wide tax evasion, uneven enforcement, and special tax privileges, are likely yielding significantly different tax burdens for taxpayers with equal bases.

A third possible method of gauging tax policy reform performance is to look at how the private sector has reacted, in particular, how Foreign Direct Investment (FDI) has flowed into CITs. While there are many determinants of FDI flows, such as political stability,<sup>61</sup> a tax system that is inefficient, unfair, costly to comply with or unpredictable can become a major obstacle to FDI.<sup>62</sup> There is some indication that tax climate may have played a role in attracting and retaining FDI in CITs (OECD, 1995b, 1995c; Edmiston, et al, 1999). As illustrated in Table 5, CEE countries and

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<sup>60</sup> See Martinez-Vazquez and Wallace (forthcoming).

<sup>61</sup> In a survey of 117 western manufacturing companies, Lankes and Venables (1996) found CIT's reform progress, political stability, and perceived risk all significantly influence FDI inflows.

<sup>62</sup> See, for example, Branson, de Macedo, and von Hagen, 1998. However, in general it is extremely difficult to separate the effects of tax reform and those of institutional and structural reform throughout an economy.

the Baltics, which reformed earlier and deeper, did receive a disproportionate share of accumulated FDI in the CITs through 1998.<sup>63</sup> But, these are also the CITs that took broader reform efforts.

Several lessons emerge from the tax reform experiment in CITs. First, a country's history and starting point significantly influence the process of tax reform. This is no surprise given the experience with tax reform in Western countries.<sup>64</sup> But for CITs there was a big gap between the philosophy, practices, and institution of tax systems of centralized planning and those of market economies. There still can be no complete understanding of the current problems of tax systems in CITs without a good knowledge of the institutional and behavioral legacies of centralized planning.

Second, tax systems are as good as their enforcement. The experience of CITs clearly confirms that effective tax reform cannot be accomplished in isolation from the current capabilities of the tax administration systems and taxpayers' culture.<sup>65</sup> In retrospect, the most serious mistake CITs collectively made was to focus primarily on modernizing tax policies and relegating tax administration and taxpayer compliance issues to a remote second place.

Third, tax policy reforms often did not measure up to the desirable standards because they did not carefully assess different options against explicit economic objectives, or because they were not comprehensive, or because they were not swiftly enacted by parliament (after careful preparation) and were not left unmodified for a sufficient length of time. With the exception of a few CITs, short-cutting the preparation stage led inevitably to greater difficulties with passing the laws and to continuous *ad hoc* patching of the system. The rapid succession of changes created confusion among tax administrators and taxpayers alike and added to the uncertainty for domestic and national investors. As illustrated by the experience of Kazakhstan and Georgia, deliberate preparation for tax reform can be conducted in a reasonable period of time, providing opportunities to educate

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<sup>63</sup> The exceptions are oil-rich countries such as Azerbaijan and Kazakhstan.

<sup>64</sup> See, for example, Feldstein (1976).

<sup>65</sup> See, for example, Slemrod (1990) and Alm (1996).

policymakers and practitioners on the intricacies of the reform and building consensus for the reform program. Careful preparation and consensus building made possible the swift passage of the tax codes by the parliaments in these two countries.

Fourth, most CITs found it difficult to internalize the lessons from their own past and those from western countries on the need for simplicity, economic neutrality, and stability. The majority of CITs continued to favor an interventionist stand providing special regimes and tax treatment, which in turn, have led to tax erosion, distortions, abuses, increased compliance and administrative costs, and taxpayer inequities and resentment. In many cases, compliance costs for taxpayers have been kept high by needless complexity in the tax laws, and unnecessary requirements, such as filing balance sheets and income statements every quarter or physically queuing for a long time to pay taxes.

Fifth, the reform of tax policy, the reform of the system of intergovernmental fiscal relations, and the modernization of tax administration are closely intertwined in most CITs. Therefore, the reform of revenue assignments at different levels of government to increase efficiency and accountability of subnational governments needs to be integrated with the reforms of tax structure and administration. Similarly, no tax policy and administration reforms are likely to succeed without taking into account their interplay with intergovernmental fiscal relations.

Sixth, to be effective and successful, tax reform needs to be accompanied by institutional and structural reform throughout the economy. CITs that moved deliberately to restructure their economies and institutions, also fared better fiscally over the past decade (Czech Republic, Estonia, Hungary, Latvia, Poland, and Slovenia). These CITs reduced the need for piecemeal reform later on in the transition, thereby creating a climate more favorable to domestic and foreign investment. In particular, institutional reform in areas complementary to fiscal reform such as accounting systems and enforcement of bankruptcy laws have proven critical.

What recommendations can be made based on these lessons for future tax reform in CEE, the FSU, and Southeast Asia? First, for those countries still lagging in comprehensive tax policy reform, it will be critically important to develop a strategic plan of tax reform with explicit objectives and explicit means to achieve them. A strategic plan for tax reform should seek to build consensus among stakeholders, including policymakers, practitioners, and taxpayers regarding the objectives of the tax system and the means of achieving those objectives in the simplest and most efficient and equitable manner. Implementing a strategic plan adequately will require investing resources in the development of data bases and the methodologies required to analyze the potential effects on revenues, resource allocation and tax burden distributions of alternate tax policies. Second, practically all CITs should simplify their tax systems, and at the same time increase revenues and horizontal and vertical equity, by reducing or eliminating tax holidays and other forms of preferential tax treatment. In particular, CITs should avoid competitive races to the bottom, granting additional tax preferences to attract foreign investors. There is no proof whatsoever that these tax preferences are more effective than stable and certain tax environments in attracting investment. Tax preferences induce higher taxes and further distortions in other areas of the economy. Third, CITs must move aggressively to plan the modernization and reform of their tax administrations. The past decade has illustrated that without the comprehensive reform of the tax administrations, CITs' gains in the area of tax policy reform will not be fully realized. CITs should take advantage of the lessons learned from tax administration reform around the world and move to simplify tax administration procedures, reduce compliance costs, and increase taxpayer services. The modernization of tax administration will require political commitment to unsettle "old ways," considerable resources in training and equipment, and focused persistence on the mundane and relatively unexciting tasks of improving collections, audits, and taxpayer services. Without these reforms, it is likely that tax evasion will continue to erode revenues during the second decade of transition. Fourth, CITs, especially those in the FSU, should forgo the use of tax offsets and take



any other possible steps to discourage the use of barter and other non-monetary means of payment in the economy. No good tax policy structure and tax administration can be effective in an economy dominated by non-monetary means of payment. Fifth, the reform of the tax systems should be accompanied by aggressive reform of those institutions that frame the effectiveness of tax systems, including the introduction and enforcement of bankruptcy laws, development and implementation of modern accounting standards, and the general enforcement of contracts.

Table 1  
Income Taxation by Country <sup>66 67</sup>

	Highest Personal Income Tax Rate	Final Withholding Of Dividends and Interest	Social Security Employer Contribution	Social Security Employee Contribution	Basic Corporate Tax Rate	Excess Wage Tax	Loss Carry- Forward / Back
Albania	30	NT / NT <sup>1</sup>	32.5	10	30	No	Yes / No
Armenia	30	NT / CT	32.0	3	15-25	No	Yes / No
Azerbaijan	40	15% / 15%	37.0	2	30	No	Yes / No <sup>3</sup>
Belarus	30	15% / CT	53.8	1	30	Yes	No / No
Bulgaria	40	EX / CT	40.6 - 55.6	2.9	20-27	No	Yes / No
Croatia	35	NT / CT	20.6	20.6	35	No	Yes / No
Czech Republic	40	25% / CT	35.0	12.5	35	No	Yes / No
Estonia	26	26% / CT	33.0	0	26	No	Yes / No
Georgia	20	10% / 10%	28.0	2	20	No	Yes / No
Hungary	40	EX / CT	36.0	12.5	18	No	Yes / Yes <sup>4</sup>
Kazakhstan	30	15% / 15%	32.0	0	30	No	Yes / No
Kyrgyzstan	40	15% / 15%	33.0	NA	30	No	Yes / No
Latvia	25	None / CT	29.0	9	25	No	Yes / No
Lithuania	33	29% / CT <sup>2</sup>	30.0	1	29	No	No / No
Moldova	32	None / CT	30.0	1	32	No	No / No
Poland	40	20% / CT <sup>2</sup>	19.81-27.53	18.71	34	No	Yes / No
Romania	45	10% / CT	35.0	6	38	No	Yes / No
Russian Federation	35	15% / 15%	38.5	1	30	No	Yes / No
Slovak Republic	42	15% / CT	38.0	12	40	No	Yes / No
Slovenia	50	CT / CT	15.9	22.1	25	No	Yes / No
Tajikistan	40	None / CT	38.0	0	30	No	Yes / No <sup>3</sup>
Turkmenistan	25	15% / 15%	30.0	1	25	Yes	No / No
Ukraine	40	CT / CT	37.5	2 - 3	30	No	Yes / No
Uzbekistan	45	15% / 15%	40	3	33	No	No / No

<sup>66</sup> Source: EBRD (1999)

<sup>67</sup> Notes: (1): NT = Not Taxable, CT = Corporate Tax, EX = Exempt from Taxation. (2) The final withholding tax on dividends is creditable on the personal income tax declaration. (3) Loss-Carryforward only for enterprises with greater than 30% foreign participation. (4) Loss-Carryback only for the agricultural sector.

Table 2  
Value Added and Excise Taxation by Country<sup>68</sup>

	Primary Value Added Tax Rate	Reduced Value Added Tax Rate <sup>69</sup>	VAT Registration Threshold	VAT Levied on Imported Goods	Excise Tax Treatment of Imports vs Domestic Goods	Specific Vs Ad Valorem Rates - Alcohol and Tobacco
Albania	20	NA	Yes	Yes	Not Harmonized	Ad valorem
Armenia	20	NA	Yes	Yes	Harmonized	Specific
Azerbaijan	20	NA	Unknown	Non-CIS Only	Harmonized	Ad valorem
Belarus	20	10	No	Non-CIS Only	Not Harmonized	Ad valorem
Bulgaria	20	NA	Yes	Yes	Harmonized	Specific
Croatia	22	NA	Yes	Yes	Harmonized	Ad valorem
Czech Republic	22	5	Yes	Yes	Harmonized	Ad valorem
Estonia	18	5	Yes	Yes	Harmonized	—
Georgia	20	NA	Yes	Yes	Not Harmonized	Specific
Hungary	25	12	Yes	Yes	Not Harmonized	Mixed
Kazakhstan	20	NA	Yes	Non-CIS Only	Not Harmonized	Specific
Kyrgyzstan	20	NA	Unknown	Yes	Harmonized	Specific
Latvia	18	NA	Yes	Yes	Harmonized	Specific
Lithuania	18	NA	Yes	Yes	Harmonized	Specific
Moldova	20	NA	Yes	Yes	Not Harmonized	Specific
Poland	22	7	Yes	Yes	Not Harmonized	Ad Valorem
Romania	22	11	Yes	Yes	Not Harmonized	Specific
Russian Federation	20	10	No	Non-CIS Only	Not Harmonized	Specific
Slovak Republic	23	6	Yes	Yes	Not Harmonized	Mixed
Slovenia	19	8	Yes	Yes	Harmonized	Specific
Tajikistan	20	NA	No	Non-CIS Only	Harmonized	Specific
Turkmenistan	20	NA	Yes	Non-CIS Only	Harmonized	Ad valorem
Ukraine	20	NA	No	Non-CIS Only	Not Harmonized	Specific
Uzbekistan	20	15	Unknown	Non-CIS Only	Not Harmonized	Ad valorem

<sup>68</sup> Sources: Ernst and Young *Corporate Tax Guide 1999*, Ebril and Havrylyshyn (1999), EBRD (1999), KPMG *Country Tax Facts 1999*, and IBFD (1999)

<sup>69</sup> In general, the reduced rate applies basic foodstuffs, children's goods, and pharmaceuticals. See IBFD (1999) for further information.

Table 3  
Performance of General Government Revenues as Percent of GDP<sup>70</sup>

Country	1993	1994	1995	1996	1997	1998
Albania	20.5	18.8	24.0	18.3	16.9	20.3
Armenia	28.9	27.6	19.9	17.7	19.8	19.5
Azerbaijan	40.5	33.8	17.6	17.6	19.7	16.0
Belarus	54.3	47.5	40.9	40.9	46.1	47.8
Bulgaria	37.2	39.9	34.9	31.9	32.6	39.3
Croatia	21.7	27.7	29.2	29.2	28.4	27.8
Czech Republic	42.2	41.0	43.2	43.2	41.8	41.5
Estonia	38.5	41.3	39.9	39.0	39.1	39.1
Georgia	3.4	7.7	7.1	9.4	10.2	10.5
Hungary	45.7	45.4	42.1	39.9	37.5	41.8
Kazakhstan	21.1	18.5	16.9	13.2	13.3	13.9
Kyrgyzstan	24.7	20.8	16.7	15.9	16.2	14.8
Latvia	36.4	36.5	35.5	36.6	28.4	42.3
Lithuania	30.2	32.6	32.3	29.6	32.6	34.2
Moldova	22.8	31.3	33.9	32.1	36.3	27.6
Poland	45.8	41.9	40.9	39.8	38.8	42.5
Romania	33.9	32.1	30.1	30.1	30.7	35.0
Russian Federation	35.5	34.7	29.9	31.0	30.7	28.4
Slovak Republic	44.3	46.4	47.7	45.2	44.6	45.1
Slovenia	47.0	45.9	45.2	45.2	44.6	45.1
Tajikistan	27.1	44.5	15.2	12.1	12.6	12.8
Turkmenistan	22.6	10.4	12.5	16.9	29.2	17.2
Ukraine	42.8	41.9	37.8	36.7	38.4	37.8
Uzbekistan	36.0	29.2	34.3	34.3	30.5	33.5

<sup>70</sup> Sources: EBRD (1999) and Ebril and Havrylyshyn (1999) within 1998 data estimated by EBRD.

Table 4  
General Government Balances, Inequality and Poverty Indicators <sup>71</sup>

	1992 General Government Balance (% of GDP) <sup>72</sup>	1998 General Government Balance (% of GDP)	Gini Coefficient <sup>73</sup>	Share of Population in Poverty <sup>74</sup>
Albania	-20.3	-10.4	NA	NA
Armenia	-13.9	-5.2	38.1	44
Azerbaijan	-15.3	-4.2	45.8	60
Belarus	0.0	-0.3	39.9	23
Bulgaria	5.2	1.0	29.1	33
Croatia	-3.9	0.6	NA	NA
Czech Republic	-3.1	-2.6	25.4	1
Estonia	-0.3	-0.3	NA	40
Georgia	-25.4	-4.4	49.8	60
Hungary	-7.6	-4.6	34.8	2
Kazakhstan	-7.3	-8.0	NA	50
Kyrgyzstan	-17.4	-9.9	42.8	76
Latvia	-0.8	-0.8	34.9	23
Lithuania	0.5	-5.8	35.0	46
Moldova	-26.2	-8.1	39.0	65
Poland	-6.7	-3.0	30.2	13
Romania	-4.6	-3.3	30.3	22
Russian Federation	-42.6	-5.4	48.3	38
Slovak Republic	-7.0	-5.8	NA	1
Slovenia	0.2	-1.4	29.8	1
Tajikistan	-30.5	-3.8	NA	85
Turkmenistan	13.2	-2.7	NA	48
Ukraine	-25.4	-2.7	41.3	41
Uzbekistan	-18.4	-3.8	NA	29

<sup>71</sup> Sources: EBRD (1999).

<sup>72</sup> Data for Azerbaijan and the Slovak Republic are for 1993.

<sup>73</sup> The reported Gini coefficient is for 1993 for Belarus, 1995 for Moldova, and 1997 for Georgia and Hungary.

<sup>74</sup> The poverty line is equal to US \$4 a day, measured at Purchasing Power Parity (PPP) exchange rates.

Table 5  
Accumulated Net Foreign Direct Investment, 1993-1998<sup>75</sup>  
(In Billions of US Dollars)

Albania	0.383	Latvia	1.561
Armenia	0.328	Lithuania	1.534
Azerbaijan	3.102	Moldova	0.313
Belarus	0.455	Poland	14.75
Bulgaria	1.225	Romania	4.382
Croatia	1.984	Russian Federation	8.935
Czech Republic	9.000	Slovak Republic	1.556
Estonia	1.383	Slovenia	1.039
Georgia	0.528	Tajikistan	0.130
Hungary	13.10	Turkmenistan	0.762
Kazakstan	5.661	Ukraine	2.400
Kyrgyzstan	0.332	Uzbekistan	0.580

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<sup>75</sup> Sources: EBRD (1999) and World Development Indicators (1999). 1998 FDI data estimated by EBRD.

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